APPENDIX

FOMC NOTES
November 16, 1993
Peter Ryerson Fisher

Mr. Chairman:

We had no operations during the period, but there were some exchange rate movements of note, and I would like to address two areas:

> First, what has caused the sharp movements in the Canadian dollar and in the Mexican peso?
>
> And second, why is the dollar up against the German mark but now almost unchanged in level against the yen?

Extraordinary volatility in the Canadian dollar was caused by the recent national elections. In early October, the currency reached a six-and-a-half-year low on fears that the election would result in a minority Liberal government. It then strengthened sharply, first on the prospect, and then the fact, of a large, majority Liberal government, rising almost 4 percent before falling back by over 2 percent in the last 10 days as the deteriorating fiscal condition of the federal and provincial governments has come into focus. The Bank of Canada sold U.S. dollars during 14 days over the period and purchased U.S. dollars during 11 other days.

The Mexican peso maintained a remarkable stability through September and October. Foreign investors continued to purchase peso-denominated assets despite the strength of opposition to the NAFTA in the United States. But, as shown in Chart 1 of my written report, in the last days of October the peso began to

weaken above 3.12 new pesos to the dollar and on November 3rd fell to 3.15 -- the lower end of the Bank of Mexico's "daily management" band. The immediate cause appears to have been the combination of a Wall Street Journal report that the Fidelity mutual funds had shifted a billion dollars out of peso instruments (and into Brady bonds) and the announcement of the Gore-Perot debate which, before the fact, was widely perceived in Mexico as a grave mistake.

From November 3rd to the 8th, the Bank of Mexico sold trying to keep the peso within the 3.15 management band but then gave up and extended the band to just beyond 3.30 (almost at the lower end of the peso's crawling peg) and the peso declined to about 3.28. Overnight rates were increased from 14 to over 24 percent and the auction of 28-day government paper on November 9th saw rates increase 377 basis points, to over 17 percent. Since then, overnight interest rates have started to come down, the Mexican stock market has rallied to a series of new highs and the peso recovered sharply and has continued firming this morning, trading at 3.19.

The dollar reversed its trend against the German mark, rising 4.6 percent, as market participants came to perceive an increased likelihood, between now and March, of <u>both</u> further interest rate reductions by the Bundesbank and of a rise in rates by the Federal Reserve.

The trend of widening differentials between German and U.S. rates continued in the early weeks of the period but then reversed sharply in mid-October. This can best be seen in the differential in favor of the mark implied by the March Euro-dollar and Euro-mark futures contracts, shown in Chart 8 of my report, which widened by almost 25 basis points from mid-September to mid-October but has since narrowed by 39 basis points. This shift reflected market participants' increasingly positive view of U.S. economic data, their increasingly negative view of German and European economic prospects, and the Bundesbank's surprising October 21st rate reductions. From October 12th to November 2nd, the dollar rose from just below 1.60 to 1.70 deutche marks. The Bundesbank sold a total of dollars, principally on days when the dollar approached the 1.70 level. This morning the Bundesbank's Market repo rate came down by 9 basis points -- somewhat more than the market expected, and the dollar is again bumping up against 1.70.

During October the dollar also firmed against the yen, as the continued weakness of Japanese economic data led to increasing expectations for a further decline in Japanese interest rates and to the widespread market expectation that the dollar would reach 115 yen by year's end. Recently the dollar fell back to its levels at your last meeting. This occurred as market participants have become concerned that the extended downturn might force weak Japanese corporations to liquidate

foreign investments and repatriate capital, and that the Hosokawa government's efforts to stimulate their economy will be deemed inadequate by the Clinton Administration. In this environment last week, long-dollar positions were scaled back and the dollar traded down from 108 to below 106, but has traded back above 106 this week.

Thus, despite greater than 50 basis point increases in the differentials favoring the dollar on three-month Euro-deposits, on the March Euro-futures contracts and on ten-year government bonds, at the end of the period the dollar-yen exchange rate has once again responded principally to trade politics and to the fear of capital reflows to Japan.

Notes for FOMC Meeting
11/16/93
Joan E. Lovett

Desk operations continued to seek reserve conditions consistent with Federal funds trading around 3 percent. The borrowing allowance was cut by a total of $150 million in a series of steps that reflected the declines in the seasonal component typical at this time of year. The allowance now stands at $100 million.

The Desk faced a large reserve shortage early in the interval, stemming from high Treasury balances following the mid-September corporate and individual tax date. These tax receipts proved to be much larger than originally anticipated. Reserve shortages in subsequent weeks were mostly moderate in size and driven mainly by seasonal movements in required reserves and currency. These influences became more pronounced toward the end of the period as we approached the late-year holiday season.

Given this pattern, the Desk made heavy use of temporary RP operations of assorted sizes, types, and maturities. Some of the largest operations were arranged early in the interval to address the deep deficiencies arising from high Treasury balances, with a record $23 1/2 billion of RPs outstanding on the books on September 22. Operations included an overnight System RP that was announced a little ahead of our usual intervention time on September 30, the quarter-end and the settlement date for the Treasury's end-of-month note auctions. On a couple of occasions later on, we gave weight to a slightly

firm money market that was at odds with the reserve estimates. In actuality, each turned out to be about half right in indicating reserve availability.

As the seasonal reserve need began to deepen toward the end of the period, we purchased $3.5 billion of bills in the market on November 3. This was our second bill pass this year, and the fifth outright operation in the market. We were also a frequent buyer of securities from foreign accounts over much of the interval, but particularly in the second half. Altogether, we purchased $3.2 billion from this source to help meet current and future reserve needs, thus using $6.7 billion of the $8 billion leeway. The portfolio is up some $28 billion on the year thus far and, with reserve needs expected to continue to grow in upcoming weeks, additional outright purchases in the market are anticipated.

The funds rate averaged 3.02 percent for the full period. It averaged just about 4 percent on September 30--reaching 20 percent at one point during the day--amid a reserve shortfall, the usual quarter-end pressures, and a system problem at one bank which aggravated reserve distribution. The funds market retained some lingering firmness for several days thereafter. Meanwhile, adjustment borrowing was very low on most days, averaging just $17 million if a bulge to over $2 1/2 billion on that quarter-end date, is excluded. (It averaged $67 million overall including that episode.) I should note that the market is already thinking about the year-end when window-

dressing activities are usually more pronounced. Pressure over the turn is expected to lead to funds rate levels close to 10 percent before dropping back. Rates of 8 1/2 percent already having been paid.

Since your last meeting, interest rates on Treasury issues have moved over a fairly wide range. The nearly one-year-old rally in the fixed-income markets was initially extended by continued signs that the economy was moving ahead only slowly and that inflation remained on a downward path. Shortly after the September PPI and CPI reports were released in mid-October, the current 30-year bond yield reached a post-1977 low of 5.78 percent, with most other coupon rates down between 15 and 30 basis points from levels prevailing at the last Committee meeting.

But interest rates did not remain at these lower levels for long. Many investors were nervous about the market's ability to hold on to these gains and were ready sellers on any discomforting news. And as evidence began to accumulate over the past few weeks that the pace of economic expansion was quickening, yields across the curve backed up sharply--up some 30 to 50 basis points from mid-October lows. The backup gained momentum from actions to protect profits ahead of the year-end. Meanwhile, other factors that had provided support to intermediate- and long-dated Treasury securities also diminished: demand stemming from municipal defeasance programs was still running fairly strong at the start of the interval, but slackened noticeably in

recent weeks. And a higher rate environment has eased prepayment fears, causing some redirection of portfolios back into the mortgage-backed sector.

The improved tone to recent economic reports caused a reappraisal of the outlook and led to talk that the Fed might move to firm policy as soon as early next year. At this juncture, expectations for growth in the current quarter seem pretty uniform at 4 percent or somewhat higher. The key question is whether above-trend growth can be sustained into 1994, thereby validating the upward move in yields, or whether last year's pattern again repeats in which case the yield backup is viewed as overdone. Many analysts suspect that growth will again slacken next quarter in the face of fiscal restraint and other structural forces that have impeded the economy's advance over the past several years. Others think structural impediments have eased and believe that the bulk of the effect of higher taxes has already been experienced. Faced with these uncertainties, investors are likely to remain skittish, but the market has regained its footing in recent days as support has emerged at the higher levels. The current market view is that, while its bias may shift by year-end, the FOMC will want a solid case for actually moving, which means waiting for some of the first-quarter numbers to become available.

In the interest of time, I will forego a discussion of Treasury financing operations during the period unless there are questions. And, in a final note, Mr. Chairman, I would like to

request a temporary increase in the intermeeting leeway from $8 billion to $11 billion. As noted earlier, upcoming reserve needs, at this point, are expected to be sufficiently large and persistent as to warrant a cushion beyond the normal limit.

Michael J. Prell
November 16, 1993

FOMC Briefing

Anticipating that time would be short, I thought I'd forgo any review of the Greenbook analysis today and focus simply on a few quick data updates and some brief comments on the possible risks in the outlook.

On the first point, the data we've received since the Greenbook was completed have not altered our view of the economic situation. The main new information relates to the retail sector. Looking back at the third quarter, the revisions to August and September retail sales didn't point to any change in the estimate of consumer spending that was embedded in the advance GDP figures. Meanwhile, non-auto retail inventories were indicated to be up appreciably in September--offsetting a good part of the shortfall in manufacturing and wholesale stocks, relative to the Commerce Department's assumptions. With merchandise trade figures for September yet to be published, there is still an important gap in the data. But at this point there is no reason to anticipate an appreciable revision to the third-quarter GDP growth rate of 2-3/4 percent.

Looking to the current quarter, we would not modify the Greenbook projection that GDP growth--rounded to the nearest whole number--will be 4 percent. The latest spending indicators, October retail sales and auto sales for the first ten days of November, suggest that consumer spending will post at least a moderate increase this quarter. As indicated by the 0.8 percent gain in industrial production last month, manufacturing activity is strong, paced by the motor vehicle

and business equipment sectors; and construction also appears to have entered the fall on an upswing.

Looking ahead, as Joan suggested, the question is whether the expansion will maintain its recent upward thrust, or whether it will moderate soon. We've clearly opted for the latter alternative, with our forecast showing GDP growth slackening to 2-1/2 percent in the first half of next year. As I said earlier, I won't take the time now to walk you through the explanation of that deceleration, which was laid out in the Greenbook. Rather, I'd like to spend a couple of minutes addressing the risks in the outlook.

As always, the uncertainties surrounding our forecast are considerable. If one wanted to build the case for stronger aggregate demand growth, one might point to the possibility that the enormous improvement in cash-flow affordability will spur more homebuilding than we've projected, and with it, stronger sales of household durables; or one might argue that technological advances, competitive pressures and the quest for productivity improvement will give rise to even greater purchases of business equipment. If, on the other hand, one wished to argue for a slower growth trajectory, one might point to the possibilities that consumers will run out of steam, especially those being hit by the upcoming increases in tax payments, or that the economies of the other major industrial countries could pick up even more slowly than we've anticipated.

Admittedly, it wouldn't take much imagination to come up with rationales for reversing the signs on one or more of the sectoral stories I've just mentioned; for example, it is conceivable that concerns about high unemployment could prompt the adoption of more stimulative policies in some major countries than we've assumed. And other aspects of the forecast could be questioned one way or the other

as well. As I personally add up all the risks I perceive, although I'm comfortable with the Greenbook output path as a meaningful forecast, I'm inclined to think the probability distribution around that path may be somewhat skewed to the upside.

This observation in turn has implications for the risks attending our inflation forecast. In arriving at the Greenbook projection, we hacked our way through the statistical and analytical thicket and concluded that the odds favor a slight further deceleration of core consumer price inflation over the coming year. But, if output growth were to exceed what we've forecast substantially--say, remaining close to 4 percent--and if that extra growth were to reflect stronger demand rather than a favorable productivity surprise, the margin of effective slack in the economy would be quite limited a year from now. Moreover, there might well be some so-called "speed" effects in the interim. This obviously would jeopardize the underlying trend of disinflation.

I should emphasize that I don't assign a high probability to the alternative scenario I've just described. But, given the already reduced amount of slack in industrial capacity and labor markets, the need for continued close monitoring is clear.

November 16, 1993

FOMC Policy Briefing
Donald L. Kohn

The Greenbook outlined a staff forecast in which upcoming fiscal restraint and other factors contribute to a moderation of growth in output beginning early next year from the stronger pace expected in the second half of 1993. In the forecast, the economy overall would grow roughly in line with its potential, maintaining an appreciable and persistent margin of slack. If the Committee agreed that this was the most likely outcome, and the risks around it were seen as fairly well balanced, an unchanged policy and symmetrical directive could be seen as a logical policy position.

However, Mike also noted the upside risks to the forecast, and the possibility, should those risks be realized, of a dwindling margin of economic slack by late next year. One possible interpretation of the recently stronger economic data is that the accommodative stance of monetary policy is beginning to show through more definitely into aggregate demand as balance sheet and credit-supply constraints abate. If strength in aggregate demand indeed persists, the current GDP gap is not so large that the Federal Reserve could delay tightening for long without risking "getting behind the curve" in heading off future increases in inflation. If the Committee saw the risks tilted in this direction, it might wish to be ready to react fairly promptly over the intermeeting period to further signs of firming in the expansion. This attitude presumably would be reflected in an asymmetrical directive.

Unless the odds on sustained stronger expansion were considered to be high, however, there might be some reasons for caution

in moving to an asymmetrical directive. For one, financial data are at best mixed in terms of signalling or confirming an appreciably higher track for the economy. Real interest and exchange rates have risen partly in anticipation of such a track, but this rise in itself should help to limit the degree to which stronger demand shows up in actual spending. To be sure, at some point the restraining effects of the higher interest and exchange rates would have to be validated and reinforced by tighter monetary policy.

Growth of money and credit has strengthened somewhat from earlier this year and money growth was a little faster than we anticipated at the last FOMC meeting. However, as noted in the bluebook, much of the recent overage was due to special factors or movements in volatile components. Expansion of broad money still remains quite sluggish for the year to date, and looking forward, we expect continued modest increases in M2 and M3 over coming months, as mutual funds continue to attract savings. Despite increased willingness to lend and borrow, private credit flows remain below the pace of spending, and are expected to continue that way.

Another reason for caution might be seen just in the fact that the Federal Reserve has moved toward asymmetry earlier this year without a follow-up action. In this context, the Committee might want to be fairly serious about the possibility of tightening over the intermeeting period before adopting a non-asymmetrical directive. Frequent shifts to asymmetry without follow-up action could be seen as reducing the value of asymmetry as an internal directive for policy over the intermeeting period and its value as a signal, when it is published, of the concerns of the Committee.